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Attachment 1

May 15, 2006

AGENDA ITEM 8-A

TO: MEMBERS OF THE INVESTMENT COMMITTEE

I. SUBJECT: Assembly Bill 2941 (Koretz) – As Amended April 6, 2006

Sudan Divestment

Sponsor: Sudan Divestment Task Force; Sacramento Committee on Conscience

II. PROGRAM: Legislation

III. RECOMMENDATION: Information Only

IV. ANALYSIS:

This bill would prohibit the California Public Employees' Retirement System (CalPERS) and the California State Teachers' Retirement System (CalSTRS) from investing in a company with business operations in the Sudan, as specified in the bill, and requires the boards of these retirement systems to sell or transfer any investments in these companies and report to the Legislature regarding these investments.

CalPERS staff is currently in discussions with the author and sponsor of the bill regarding amendments. Since these discussions are ongoing, we do not recommend a position at this time.

Background

Constitutional Authority and Fiduciary Responsibility

Article XVI, section 17 of the California Constitution gives the boards of public retirement systems in California plenary authority and fiduciary responsibility for investment of pension assets and administration of the system. The Constitution expressly provides that the retirement board of a public pension fund shall have the sole and exclusive fiduciary responsibility over the assets of the public pension or retirement system. It further requires the fiduciary of the public pension or retirement system to discharge his or her duties solely in the interest of, and for the exclusive purpose of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system. The Constitution also requires the boards of public pension funds to diversify the investments of the systems so as to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly not prudent to do so.

The Constitution, however, provides that the Legislature may by statute continue to prohibit certain investments by a retirement board where it is in the public interest to do so, and provided that the prohibition satisfies the standards of fiduciary care and loyalty required of a retirement board.

In accordance to California Constitution Article XVI, Section 17, the Board's constitutional duties take precedence over any other considerations. Other considerations will be entertained only when not in conflict with any of these duties. It is recognized that while investments are made for the sole benefit of the System's beneficiaries, collateral benefits may also result.

<u>CalPERS' Constructive Engagement Approach</u>

CalPERS believes that constructive engagement is the most powerful tool available to investors to effect change, and it is through active ownership that CalPERS constructively engages those portfolio companies whose corporate governance, social, and environmental practices could lead to value destruction. In response to the atrocities taking place in Sudan, CalPERS has developed an extensive framework to support a constructive engagement plan with CalPERS' portfolio companies that have business operations in Sudan. Since November 2004, CalPERS' efforts to identify and engage companies operating in Sudan have been:

- Consulted four Federal Authorities (U.S. Department of Commerce, U.S. Department of State, U.S. Department of the Treasury, and the U.S. Securities and Exchange Commission) with a coalition of 49 other pension funds;
- Contacted 1,869 portfolio companies and 46 external managers;
- Formed a second coalition (Sudan Coalition) with four other public pension funds to constructively engage companies;
- Continued monitoring of the U.S. Department of the Treasury's Office of Foreign Asset Control (OFAC).

Through the collective efforts discussed above and a review of multiple sources, CalPERS initially identified five companies in the total CalPERS' portfolio that were doing business in Sudan. Through continued efforts of CalPERS staff, in conjunction with third party sources, CalPERS has identified several additional portfolio companies as doing business in the Sudan.

In addition to identifying companies through third-party sources such as the Office of Foreign Asset Control (OFAC) and the Sudan Coalition, staff continues its efforts to identify credible third-party consultants to assist in the identification of companies doing business in Sudan. Staff has engaged F&C Asset Management, a leading investment company located in the United Kingdom, and continued to dialogue with Oxford Analytica to explore potential opportunities to assist CalPERS' efforts to identify and engage companies doing business in Sudan.

CalPERS has a comprehensive ongoing constructive engagement plan with respect to portfolio companies identified as doing business in the Sudan. For more information on these continued efforts, please refer to Agenda Item 5b, Update on Investments in Companies Doing Business in the Sudan.

CalPERS' constructive engagement plan is consistent with Assembly Concurrent Resolution 11 (Dymally) (ACR 11), supported by the CalPERS board and adopted by the Legislature in 2005, which encouraged CalPERS and CalSTRS, within their fiduciary responsibilities, to encourage companies in which employee retirement funds are invested that are doing business in Sudan to act responsibly and not take actions that promote or otherwise enable human rights violations in Sudan.

University of California Recent Action

The University of California Regents voted unanimously during the March 16, 2006 Regents meeting to divest from nine companies with business operations in the Sudan, and constructively engage with other companies. This divestment action prohibits future investment in the nine companies until such a time as there is compelling information that a company has materially improved its operation and is no longer thought to be contributing to the suffering in Darfur. Implementation of the proposed divestment policy is conditioned upon enactment of indemnification legislation.

CalSTRS Recent Action

During the April 6, 2006 CalSTRS Investment Committee meeting, the Committee unanimously approved the following motion:

"*It is the intent of the Board to move forward to divest its holdings from companies identified as doing business with the Government of Sudan, taking into consideration the same general criteria utilized by the UC Regents and subject to the investment staff determining that such action would be prudent and consistent with the System's fiduciary duties and that suitable alternative investments would be available. Staff is directed to bring back at the June meeting any appropriate analysis, legal opinions, and procedural requirements as required. Such action would be subject to the indemnification of the Board members, consistent with the indemnification of the UC Regents.*"

Related Legislation in Other States

Legislation pertaining to Sudan divestment has been introduced in 20 states, with Illinois, Louisiana, Maine, New Jersey and Oregon adopting some version of divestment legislation.

Illinois enacted SB 23, which generally proposes no new loans or investment in companies doing business with Sudan. From the effective date of January 1, 2006 this bill requires a minimum of 60 percent of the system's funds to be divested within 12 months and 100 percent within 18 months.

Louisiana enacted Act 9 (formerly HB 658). This bill stated that a system "may, but is not required" to divest of holdings in a company with ties to a prohibited nation, which included Sudan. This bill was signed into law by Governor Kathleen Blanco May 27, 2005.

Maine enacted LD 1758 on April 5, 2006, requiring the Maine State Retirement System to review the extent to which the assets of any state pension or annuity fund are invested in the Sudan and divest itself of any such holdings.

New Jersey enacted Act 3482 (formerly HB 3482) requiring divestment from foreign companies "engaged in business with or in" Sudan and/or ties in Sudan; prohibits further investment; and requires a report to the legislature. Act 3482 was signed into law by Governor Richard Codey July 28, 2005.

Oregon enacted Act 1089 which ensures that State funds are not invested in any company that the council knows is doing business in Sudan, for as long as the Sudanese government's campaign of human rights violations, atrocities or genocide continues in Sudan. This bill was signed into law by Governor Ted Kulongoski August 23, 2005. The Act becomes effective immediately, and the State Treasurer is expected to report on the investigation of each company's business involvement in Sudan on January 15, 2006.

Proposed Changes

This bill would prohibit the CalPERS and CalSTRS from investing in a company with business operations in Sudan, as specified, and require the boards of these retirement systems to sell or transfer any investments with these companies and report to the Legislature regarding these investments, including:

1. Prohibit the boards of CalPERS and CalSTRS from investing in a company with business operations in the Sudan that meet all of the following criteria:

    a. The company provides revenues to the government of Sudan;
    b. The company with business operations in Sudan devotes a majority of its business operations in Sudan to the government of Sudan or has limited business operations in the Eastern, Southern and Western regions of Sudan; and
    c. The company has demonstrated complicity in the Darfur genocide or failed or refused to take substantial action related to the government of Sudan because of genocide.

2. Require CalPERS and CalSTRS to contract with a research firm to determine those companies that have business operations in Sudan and to report its findings to the board on or before March 30, 2007, and to update those reports as circumstances in Sudan change.

3. Require the board in instances where the investment in a company doing business in Sudan is via an index fund or other similar investment or in an account commingled with the investments of other institutional investors, to contact the fund or account manager in writing to request removal of the company with business operations in Sudan from the fund.

4. Require the board to submit a written notice to each company identified in the research firm's report notifying that company that the board will reduce its investments in that company unless the company takes substantial action, as defined, related to the government of Sudan. If, in the opinion of the board, the company does take substantial action within 90 days of the mailing of such notice, then the company will not be subject to the divestment provisions.

5. Establish the following timeframes under which the boards must stop investing in companies with business operations in Sudan if the board finds that a company meets all of the criteria specified above and for divesting of their holdings in those companies:

    a. On or before January 1, 2007, the board shall not make additional or new investments or renew existing investments in those companies.
    b. On or before June 30, 2007, the board shall reduce its investments in those companies by 50 percent.
    c. On or before January 1, 2008, the board shall reduce its remaining investments in those companies.

6. Require the boards to report to the Legislature by June 30, 2007, and annually thereafter, on their investments with companies with business operations in Sudan, as specified.

7. Indemnify, by the General Fund, present and former board members, state officers and employees, and investment managers from all liability, losses or damages sustained by reason of any decision not to invest in companies with business operations in Sudan pursuant to the provisions of this bill.

8. Provide that nothing in the bill's provisions shall be construed to alter or diminish the existing fiduciary or statutory obligations and other terms, conditions, or limitations on the investment of retirement system assets for the exclusive benefit of the participants of the retirement system and their beneficiaries.

9. Provide that these requirements only remain in effect until Sudan halts genocide for 12 months as determined by the State Department and Congress or if the United States revokes its current sanctions on Sudan.

Legislative History

2005 Chapter 57 (AJR 6, Koretz) – Declared the Sudanese government should condemn all actions and crimes committee by the Janjaweed, ensure all militias are disarmed and disbanded, humanitarian workers must be given full and unimpeded access to Darfur, Sudan should put in measures to ensure these crimes never happen again, and that these resolutions be transmitted to the highest federal authorities and the United Nations Secretary General. *CalPERS Position: None*

Chapter 98 (ACR 11, Dymally) – Encouraged CalPERS and CalSTRS, within their fiduciary responsibilities, to encourage companies that invest in Sudan to act responsibly and not take actions that promote or otherwise enable human rights violations in Sudan.
CalPERS Position: Support

2001 SJR 9 (Costa) – Would have urged the Federal government to assume its proper leadership role in assisting investors in avoiding investing in entities that are deemed threats to the national security of the United States. Failed passage. *CalPERS Position: Sponsor*

2000 AB 107 (Knox) – Would have prohibited CalPERS and CalSTRS from making any new or additional investments in tobacco companies beginning January 1, 2001 and requires divestment of existing investments by July 1, 2002. Failed Passage. *CalPERS Position: Oppose*
SB 1928 (Haynes) – Requires CalPERS and CalSTRS to report on the extent to which they are invested in foreign companies that pose threats to national security, and encourages the boards of these pension funds not to invest in those companies. Held in Assembly.
CalPERS Position: Oppose

1998 AB 1679 (Perata) – Would have prohibited state trust fund and state money investments in tobacco companies. Failed Passage.
CalPERS Position: Oppose

AB 1744 (Knox) – Would have prohibited CalPERS and CalSTRS from making new or additional investments in any tobacco company on or after January 1, 1999. This bill would also require a phased divestment of those investments beginning January 1, 2000 and continuing until January 1, 2002. Failed Passage. *CalPERS Position: Oppose*

SB 1433 (Hayden) – Would have required CalPERS and STRS to not make new or additional investments in tobacco companies. Failed Passage. *CalPERS Position: Oppose*

1994 Chapter 30 (SB 1285, Watson) – Repealed provisions prohibiting investments in South Africa. *CalPERS Position: Support*

1986 Chapter 1254 (AB 134, Waters) – Prohibited the use of state trust funds or state moneys to make additional or new investments, or to renew existing investments in firms doing business with or in South Africa as of January 1, 1987. *CalPERS Position: Neutral*

1983 (AB 808, Watson)—Would have prohibited the use of state funds for investment in the stock of financial institutions having outstanding loans to the government of South Africa after January 31, 1985. Would have required complete divestment of state funds in any American company doing business in South Africa by January 1, 1989. Provided an exception for any financial institution adopting a policy including a commitment not to renew existing loans or to make new loans to the South African public sector. Vetoed by Governor Deukmejian. *CalPERS' Position: Oppose*

Issues

1. Arguments in Support

   The sponsor, Sudan Divestment Task Force, states, "The Sudanese government supports and finances the Arabic militia known as the Janjaweed who are carrying out what is referred to as ethnic cleansing. Several major companies including ChinaPetrol, ABB, Ltd., Alcatel and Siemens AG all have business ties with the Sudanese government and all government-controlled entities. These companies present a financial risk and a moral threat to their shareholders. Both CalPERS and CalSTRS are in unique positions to put pressure on the Sudanese government to stop supplying arms to the Janjaweed militia. By divesting our western interests, we encourage the government to act responsibly and not take actions that promote or otherwise enable human rights violations."

   Organizations in Support: Sudan Divestment Task Force (sponsor); Sacramento Committee on Conscience (sponsor); Phil Angelides, State Treasurer; California Federation of Teachers; American Federation of State, County and Municipal Employees.

2. Arguments in Opposition

   There is no known registered opposition at this time.

3. The requirements and restrictions imposed by AB 2941 would impinge upon the Board's constitutional plenary authority and fiduciary responsibility for investment of the System assets.

   The bill would require specific action by the Board with regard to certain investments and within limited timeframes. The bill would prohibit the Board from making, after January 1, 2007, additional or new investments in companies meeting indeterminate criteria outlined in the bill. In addition, the bill would require the Board to reduce, and ultimately completely divest itself of, investments in companies meeting the criteria within the timeframes set forth in the bill. These legislatively mandated investment restrictions, and strict deadlines, would impinge upon the Board's constitutional plenary authority and fiduciary responsibility to invest the assets of the retirement fund in the exclusive interest of CalPERS' participants and beneficiaries. In addition, the bill, in its current form would infringe upon the Board's fiduciary duties to maximize investment returns on behalf of its membership and meet its benefit obligations.

As fiduciary of the CalPERS fund, the Board has ultimate responsibility and liability for investment decisions. The Board must establish investment policies that are in the best interests of plan beneficiaries, as well as meet the tests of procedural and substantive prudence in reaching its investment decisions.

4. Timelines in the bill may not be sufficient

   The bill requires the board to contract with a research firm to determine which companies have business operations in Sudan and report such findings to the Board by March 30, 2007. The Board then must notify each company identified in the report that the board will reduce its investments in that company within 90 days unless the company takes substantial action as defined. These timelines may not be achievable in most circumstances. There are many factors that will determine how well CalPERS can comply with these timelines, some outside of CalPERS' control, such as the ability of an independent research firm to clearly identify and document companies which meet divestment criteria, additional research by an independent research firm, or additional input from federal agencies to identify the extent of a company's role with the government of Sudan.

   Staff has requested that Assembly Member Koretz consider amending AB 2941 to extend the time periods, but, to date, he has not done so.

5. Indemnification provision does not indemnify the fund or the research firm

   The bill includes an indemnification provision identical to the one contained in AB 134 that enacted the South Africa divestment requirement in 1986. Specifically, this bill would provide that the State General Fund shall indemnify present and former CalPERS Board members, state officers and employees, and investment managers from all liability, losses or damages sustained by reason of any decision not to invest in companies with business operations in Sudan pursuant to provisions of this bill.

   Staff has requested that Assembly Member Koretz consider amending AB 2941 to expand the indemnity provision to cover losses to the retirement funds, themselves, and to include the research firms as indemnitees. However, Assembly Member Koretz has not, thus far, amended AB 2941 to so extend the indemnification provision.

6. Holding the Research Firm to the Same Fiduciary Standards as CalPERS

   This bill requires the board to contract with a research firm to determine those companies that have business operations in Sudan. CalPERS must then proceed with procedures to engage the company and/or divest, within their fiduciary duty. In order for CalPERS to base its investment decisions, which will be held to the Board's fiduciary responsibility, on a research firm's recommendation, the research firm should be held to the same fiduciary standards. This alignment is necessary to ensure the same level of criteria is used in the identification process as in the divestment decision process.

7. CalPERS' Legislative Policy Standards

   The Board's Legislative Policy Standards suggest an oppose position on proposals which impose any investment mandate or restriction on the Board's investment authority, or proposals which create unreasonable cost or complexity for the administration of the system. AB 2941, in its current version, would infringe on the Board's authority to decide whether or not CalPERS should retain or divest its holdings in companies doing business in Sudan. Staff will continue to work with the author to seek amendments to address the identified issues.

V. STRATEGIC PLAN:

This item is not a specific product of the Annual or Strategic Plans, but is a part of the regular and ongoing workload of the Office of Governmental Affairs.

VI. RESULTS/COSTS:

AB 2941 would impinge on the Board's policy-setting and decision-making authority with regard to investments in certain companies doing business in Sudan. However, the Board would retain fiduciary responsibility and liability for the impact of this legislative mandate. Nothing in current law precludes the Board from reviewing any and all factors that it deems appropriate in making investment decisions, including a decision to divest. As fiduciaries, the Board must maintain complete authority in establishing and implementing investment policy.

It is difficult to determine the cost of AB 2941 because the actual cost of this bill will depend on the following: (1) the companies identified by the research firm; (2) the criteria for divestment provided in the final version of the bill, (3) CalPERS' holdings in those companies; and (4) the timing for such divestment.

Program Costs

Cost of Transitioning the Securities for Divestment into Other Securities

One time costs per security:

Again, this cost will depend on the CalPERS' holdings in the companies identified by the research firm and the criteria for divestment in the enacted version of AB 2941, but it is estimated that the average transaction cost of divestment will be approximately $1.9 million per security. Transaction costs will vary based upon the shares held in any individual company. This cost analysis was reviewed by Wilshire Associates, the Board's independent pension consultant, and deemed to be reasonable. This estimate includes commissions to sell the securities, local country taxes, the commissions to redeploy the capital as well as the commissions and taxes to reinvest the capital once the divestment period is over.

<u>Other Unquantifiable Costs</u>

There are a number of other costs not included in the analysis above because they are not currently measurable; among them are "market impact costs" related to security sales and "opportunity cost" related to lost appreciation on the securities in the event they appreciate in price. These costs cannot be predicted, but may be substantial.

<u>Any such decrease in investments will ultimately be paid for by the employers – the State, Schools, and Contracting Public Agencies</u>

In the event that there is a decrease in investment returns as a result of divestment, the employers would be responsible for making up the difference because member contributions are fixed by law.

<u>Administrative Costs</u>

CalPERS estimates administrative costs to be between $125,000 to $150,000 as outlined below.

<u>Research Firm</u>
The cost of a third party research service to develop a list of companies from which to divest will be approximately $50,000 per year. It is anticipated that CalPERS will need this list for at least two years for a total of $100,000.

<u>Fiduciary Counsel</u>
The estimated cost of an outside fiduciary counsel opinion will be approximately $25,000 to $50,000.

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